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Ms. Jennifer J. Johnson
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Board of Governors of the
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20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Ladies and Gentlemen:

U.S. Bancorp welcomes the opportunity to respond to the Agencies' Advance Notice of Proposed Rulemaking ("ANPR") for advanced approaches for measuring regulatory capital. U.S. Bancorp appreciates the effort the Agencies are making to work with the banking industry on developing a more risk sensitive capital accord.

This letter is composed of the following sections.

1. General Comments
2. Capital Framework
3. Credit Risk Capital
4. Operational Risk Framework
5. Securitization Data Collection Requirements
6. Disclosure Requirements
7. Cost of Implementation

1. General Comments

U.S. Bancorp supports the idea of updating the regulatory capital framework to include a more risk sensitive measure of capital. We believe that this is consistent with a safe and sound banking system. U.S. Bancorp broadly supports the Advanced Internal Ratings Based Approach ("AIRB") conceptual framework of probability of default, loss given default and exposure at default. U.S. Bancorp also supports the announcement of the Basel Committee to simplify the Basel II Accord. We believe that the current capital rules should be updated to a more risk sensitive measure. However, the complexity of the current proposal is greater than necessary.

Given the recent announcement that the Basel Committee will be redefining the regulatory capital requirements to include only unexpected losses and effectively excluding expected loss from regulatory capital, we urge the agencies and the Basel Committee to open the issue of the definition of regulatory capital. U.S. Bancorp believes that you cannot separate these two issues. We believe that the regulatory definitions of capital and the accounting definitions of capital need to be aligned.

U.S. Bancorp supports the three pillar concept used in the ANPR. We believe that shifting the operational capital requirements to pillar two should further strengthen this concept. This belief is founded on the idea that the best method of managing and reducing operational risk is the prudential use of controls. We are very concerned that a focus on operational capital requirements will shift focus from managing operational risk to managing operational capital requirements. We don't believe that the capital attribution process for operational risk has evolved sufficiently to warrant a pillar one treatment. We believe that the adoption of sound practices for operational risk management is the prudent course of action.

U.S. Bancorp urges the Agencies to delay the implementation date of the capital rules. The proposed implementation timeframe specifies that all data collection be in place by January 2004, however, the final version of the rules have not been specified and are not expected until the middle of 2004. The changes required to existing data systems and creation of new data systems to collect the detailed data required by the ANPR will take at least a year to create. These data systems will require U.S. Bancorp and our software vendors to expend substantial time and effort to complete the required changes. In order to reduce the implementation costs we believe that the requirement for the start of data collection should be specified as one year after the finalization of the rule. The final implementation of the rule should remain three years after the inception of data collection.

2. Capital Framework

Competitive Impact

The proposed scope of application of the ANPR to only the largest banks raises the issue of the impact on the banking industry. It is clear that these rules are having an effect already on the behavior of the banking industry. The proposed rules will create a systemic capital arbitrage within the industry. The higher quality credit portfolios will be incented to migrate to the larger banks and the lower quality portfolios will be incented to migrate towards the smaller banks not required to implement the ANPR. This shift of credit risk from the larger more sophisticated banks to the smaller banks and non-banks will have a profound impact on the ability of the banking sector to provide credit to the economy.

Capital Definition

U.S. Bancorp recommends that the Agencies and the Basel Committee reconsider the definition of capital. We believe that current definition of regulatory capital excludes some elements of shareholder equity that serve as capital. U.S. Bancorp strongly believes

that the definition of capital must be revisited contemporaneously with the risk based capital requirements. The current definition of regulatory capital excludes intangible assets that we believe should be included.

The treatment of the capital requirements for asset management and merchant processing intangibles should be revised. The capital requirement for these businesses is greater than the capital requirements of non-bank entities. We believe that the treatment of these businesses gives an unfair competitive advantage to non-bank asset managers and merchant processors. Asset management and merchant processing are important businesses for many banks. The customers of banks need these services, however, if the capital requirements for these businesses remains artificially high, banks will over time lose this business to non-bank competitors due to the higher capital requirements.

U.S. Bancorp believes that substantial improvements over the past several years in GAAP standards have changed the nature of these intangible assets. The accounting standards hold the valuation of these assets to a high standard that provides a high degree of assurance that the fair value can be realized. These accounting standards have created a level of assurance in the valuations such that the automatic exclusion of these assets is no longer warranted. U.S. Bancorp urges the Agencies to consider the definition of regulatory capital as a critical component to the revision of the capital rules.

Revised Capital Framework

On October 11, the Basel Committee announced a number of changes in the proposed framework of the Basel II Capital Accord. One of these changes was the exclusion of expected losses from the regulatory capital requirements. In principle U.S. Bancorp supports the exclusion of expected losses from regulatory capital requirements. I encourage the regulators to work in consultation with the industry on determining the appropriate methods for framing the capital rules. U.S. Bancorp is prepared to work closely with the Agencies as part of an industry group in formulating a capital framework and developing the calibration of the capital rules.

U.S. Bancorp supports the principle that the overall capital in the system remains the same, provided the treatment of innovative capital instruments remains unchanged. Many banks use innovative tier one capital instruments as a means to provide necessary regulatory capital. Potentially, FIN 46 may eliminate these instruments on a go-forward basis. Absent the development of new replacement instruments, we would encourage the Agencies to revisit the tier one capital requirements. We believe that in the long-run replacing innovative tier one capital with more expensive forms of capital will have a negative impact on the risk appetite, profitability and competitiveness of the banking industry.

Excessive Prescriptiveness

The Draft Supervisory Guidance (DSG) is very detailed and prescriptive in the specifications of the infrastructure and management processes surrounding the proposed capital rules. The level of specificity contains some inherent contradictions and overly burdensome stipulations. The data retention requirements include stipulations for five

years of historical data, and also "cradle-to-grave" data retention. The ANPR references maintaining the key data supporting a rating, while the DSG suggests that all possible rating factors be retained whether or not they are currently used in establishing the rating.

We would suggest a more principle-based approach. Clearly it is important to retain key data for a relevant period of time. We believe that this determination of key data elements should be subject to management discretion and supervisory oversight. Establishing data retention requirements for all data for an indefinite period of time is not efficient, practical or necessary. Ratings migration data should be maintained for a minimum of 10 years. Loan rating factors by loan should be maintained for at least five years. The use of stress testing should be retained as a means of ensuring that prior credit cycle events be evaluated. The use of stress testing is a best practice risk management technique for evaluating the prior credit cycle events that fall outside of the 10 year data retention time period.

3. Credit Risk Capital

Definition of Default

The definition of default is too prescriptive for wholesale and retail exposures. Few banks recognize all types of defaults specified by the regulators. As an example "silent defaults" are not generally recognized for wholesale exposures. For retail exposures, inclusion of distressed restructuring or workout involving forbearance is not currently recognized as a default. The definition imposed by the ANPR guidelines will impose additional costs on banks, as they will be required to maintain and report on multiple default types to external sources.

SME Definition

U.S. Bancorp recommends that the definition of SME be revised. The current proposal of \$50mm of assets or annual sales, in our opinion, creates an unnecessary data collection burden. The purpose of the SME category is to reflect a lower correlation factor. We believe that this is due to the size of the loan rather than the size of the borrower.

Take the example of a leasing portfolio. An office equipment leasing portfolio is comprised of small ticket equipment. Companies of all sizes use this type of equipment. Using the size of the loan or lease as a proxy for diversification is a reasonable simplification of the capital rules. Mandating the collection of revenue data for the company as part of the capital calculation is a complication that is not necessary in our view.

We believe that concern that banks will arbitrage the capital rules by making many small loans as a means of circumventing the higher capital requirements of the corporate classification can be mitigated by the Agencies through pillar two. Banks as a normal part of their risk management practices track concentration risk. This reporting can be effectively utilized by the regulatory agencies as part of a pillar two review of capital adequacy.

We believe that pillar two can be used as an effective means of addressing concentration risk. U.S. Bancorp has been steadily working over the past several years to reduce the risk profile of the bank. Reducing concentration risk has been an important element of this risk reduction. We recommend that the Agencies consider eliminating the SME curve and recalibrate the corporate curve using assumptions of greater diversification. Calibrating the capital curve for a diversified portfolio will serve as an incentive towards better risk management when coupled with a pillar two review of diversification against the pillar one standard.

LGD Floor for Residential Mortgages

The proposed 10% LGD floor for residential mortgages is too high. We believe that establishing an arbitrary floor is not necessary. A 10% floor is not appropriate for certain segments of the residential portfolio, particularly low loan-to-value loans or loans with PMI. The reliance on loss experience through-the-cycle and the conservative requirements built into the LGD specifications will provide an appropriate level of conservatism. A 10% LGD floor is an excessively conservative assumption that we believe should be eliminated from the ANPR.

Home Equity Loans

The inclusion of home equity loans with first lien residential mortgages causes home equity loans to have a capital requirement that we believe is too high. The correlation factor assigned to residential mortgages is too high for home equity loans. We encourage the Agencies to either establish a new category for home equity loans or alternatively change the correlation factor to correspond to observed industry data. We have analyzed our own experience in home equity loans and have measured a significantly lower correlation factor than that assumed in the ANPR. We believe that the use of too high of a correlation will significantly discourage the offering of home equity products by banks using the AIRB approach.

We believe that the example of the home equity product illustrates the importance of further calibration. The variation in capital requirements for different products to the same customer due to the selection of the correlation factors in each curve should be further reviewed. We believe that it is important that the capital requirements for various bank products be commensurate with their relative risk. When we compare the capital requirements of retail products by customer, the capital requirements can vary substantially. We recommend that as the curves are recalibrated for unexpected loss, that more scrutiny be applied to the relative capital requirements of the various bank products for comparable risk levels.

Short Maturity Loans

The primary purpose of the new capital accord is to establish a more risk sensitive minimum capital requirement. The assumption of a one-year maturity term for all exposures creates an increased capital requirement for loans with maturity less than one year, compared to longer maturity loans. These short dated loans should have a lower capital requirement than longer dated loans of similar risk. We believe that this

enhancement of the rules can be accomplished relatively simply and assign the capital requirements in a more equitable manner.

Unused Revolving Lines

U.S. Bancorp supports the Basel Committee's recent announcement to revisit the treatment of unused revolving lines of credit. U.S. Bancorp believes that these commitments are a low source of risk because of the management practices that monitor unused revolver commitments. U.S. Bancorp actively manages unused commitments as a means of limiting credit risk. We believe that these practices should be factored into the capital requirement calculations.

4. Operational Risk Framework

Operational Capital Requirements

U.S. Bancorp does not see evidence that the industry has evolved measurement methodologies sufficient to warrant an addition to minimum regulatory capital requirements under pillar one. The measurement of operational risk is clearly in the art phase and has not yet progressed to a science. U.S. Bancorp believes that the management of operational risk is very important. The proper focus of operational risk management should be on the continuous improvement of controls and risk assessments. U.S. Bancorp believes that the focus on capital for operational risk will detract from management's time devoted to operational risk management. U.S. Bancorp is firmly convinced that operational capital, like other risks such as interest rate risk, should be in pillar two. At a minimum, the scope of the AMA should be restricted to those banks with operational risk as their primary risk and credit risk as a secondary risk.

Operational Risks

Given the recent announcement by the Basel Committee to exclude expected losses from the risk based capital requirements, we believe that the Agencies should also revisit the topic of operational risks covered by the ANPR. In our view, the so-called high-frequency-low-severity operational losses are associated with expected loss not unexpected losses. These types of losses are characterized by credit card fraud and demand deposit fraud. These types of losses are actively managed by banks with dedicated groups of risk managers and priced into the product and services.

We believe that the proper events to be covered by a capital framework should be high severity events. Given the difficulty of modeling these types of events and the paucity of data we believe that a Pillar two approach is most appropriate. A pillar two approach can take into consideration the overall risk profile of the bank, the earnings strength of the bank, the strength of the controls and management judgement coupled with supervisory oversight.

We believe that scant attention has been paid to the importance of strong pre-provision income in any economic capital framework for operational risk. We strongly believe that banks with strong pre-provision income require less capital for operational risk, all other things equal. Banks with a strong risk management culture and strong earnings have a significant ability to absorb unexpected operational losses. We believe that this is a compelling reason for a pillar two operational capital treatment.

Opportunity Costs

Opportunity costs and other indirect costs are currently not included in the definition of operational risk. U.S. Bancorp believes that this is appropriate for the purpose of establishing minimum capital requirements. U.S. Bancorp does consider opportunity costs an operational risk, but we would characterize many of these opportunity costs within the bounds of expected losses. We believe that managing indirect costs is a leading practice for sound operational risk management. The definition of indirect costs should be limited to those costs that can be quantified.

For example, an ATM will have a targeted cash level. If the ATM carries too much cash, or runs out of cash the cost can be quantified. When too much cash is carried, the balance sheet is inflated and the excess cash must be funded with interest bearing liabilities. When the ATM runs out of cash, the number of customer transactions that were not processed can be used to quantify the processing fee opportunity cost. Another example is a security fail to deliver. This is an opportunity cost that can be quantified by the payment made to the counterparty for the delivery failure or the cost to fund the failed security delivery.

An example of an event that is difficult to assign costs would be a server outage that resulted in no lost business or overtime hours. If a server goes down and is replaced by a backup server, there may not be any financial impact to be quantified. There is an opportunity cost from the perspective that a system support person spent time returning the server to production, but if the work was conducted during normal hours and didn't require any repairs or outside expenditures, the assignment of a cost for the recovery is difficult to assign.

Insurance Mitigation of Operational Capital

The Agencies have defined insurance as a mitigant for operational risk. The ANPR limits the insurance to 20% of the gross exposure if the financial institution can show that the risk mitigants are sufficiently "capital-like". We would recommend that the 20% be eliminated and replaced with a requirement that the insurance be shown to be sufficiently "capital-like" to qualify. The justification for this change is due to the nature of operational risk. We believe that the main components of net risk are the operational risks already inherent in banking and the extent of controls in place to mitigate those risks. A bank with good controls should be able to obtain insurance for operational losses at a lower cost than the cost of capital. This type of flexibility will help ensure that the financial industry can remain competitive and a low-cost provider of services to its customers.

5. Securitization Data Collection Requirements

The ANPR proposes that rated securitizations have differentiated risk weights based on tranche thickness and pool granularity. This approach requires that banks collect data for each tranche below the tranche they own and evaluate the thickness of these tranches. We believe that this requirement is excessive. We would propose that this requirement be eased for tranches that are rate AA/Aa or higher. Exempting highly rated tranches from

this requirement will significantly reduce the burden of data collection that we feel is of limited value.

6. Disclosure Requirements

U.S. Bancorp does not believe that the additional disclosure requirements listed in the ANPR are necessary to provide the market the necessary information to evaluate the risk profile of the bank. We believe that the current disclosure requirements provide ample information to the market about the risks and controls of the bank. We believe that substantially increasing the disclosure requirements will not increase the understanding of the market.


Secondly, we are concerned that excessive disclosure will create more confusion than understanding by investors and depositors. This confusion can disadvantage banks relative to non-bank competitors and decrease the competitiveness of the banking industry.

7. Cost of Implementation

The ANPR and DSG as proposed will result in material expenditures by U.S. Bancorp to change systems and business processes. Much of the complexity is driven by the requirements to link data between systems, acquire new data or systems. Many of the changes are driven by the complexity of the proposed rules. The increased costs will have a material impact to the expense base of the bank. Some of these expenses will be absorbed by U.S. Bancorp because we will not be able to build them into our pricing structure because our competitors in the marketplace will not have to meet these rules, whether they are non-banks or banks not adopting the ANPR rules. Other costs will be able to be passed through our pricing to our customers who will bear the cost of this new regulation. However, we believe that most of the expense will be born by U.S. Bancorp and our shareholders.

We believe that simplification of the proposed rules is an important step in reducing the cost of improving the capital measures. I encourage the Agencies to consider the simplifications we have proposed in this comment letter and also work with the industry in developing further simplifications of the rules. Making these changes will provide a better balance to the cost/benefit analysis and best serve the customers of U.S. Bancorp.

Sincerely,



David M. Moffett
Vice Chairman and Chief Financial Officer
U.S. Bancorp